Take the Money and Run

Too Many Potholes after the Rally, Stock-picking is the Play

Semiconductor industry business conditions have entered a cyclical and seasonal trough and visibility to a recovery is impaired. At the same time the rally in chip sector equities since the beginning of the year has stalled and the group is now underperforming in equity markets that have reached nominal new highs amid a plethora of potential economic and political risks. This combination turns me bearish at the macro level, although a mix-master of business conditions within the group continues to offer attractive investment opportunities—albeit on a very selective basis. Let's designate it an environment calling for 'extreme stock picking.'

Stock market Bulls will argue that fundamental valuations are slightly below normal and should offer at least some incremental upside. Nevertheless, I am turning cautious after the recent rally and consider the macroeconomic and political potholes too big and numerous to bet on 'potential incremental upside' as markets establish new highs. And, by the way, that 'least-worst-among-a-bunch-of-bad-options' or 'there-is-no-alternative' argument never inspired or even comforted me that much. Potholes of risk? Let me count the ways: tax cliff, sequester, spending, debt, Dodd-Frank, Obamacare, Fannie and Freddie, euro, Greece, Italy, Spain, Cyprus, Mali, Syria, Iran, North Korea. Let's face it—if Cyprus can be a pothole, then who or what can't be?

Last year's chip industry dynamics are also influencing my thinking. Recall the SOX semiconductor index rallied 1Q12 by +20% on the hope for seasonally strong second-half business conditions, but finished the year up by only +5% on the doldrums of reality. Selling before May would clearly have been the most optimal outcome given the benefit of hindsight. At the risk of over-simplifying, this year there are two types of chip companies looking for a better second half to the year: those counting on macroeconomic stability and favorable second half seasonality; and those anticipating the production ramp of design wins on new product platforms. I am more inclined to go with the latter, but give credit to the former for admitting to the lack of customer order visibility. Stock picking is the best way to play this market in my opinion, with a sharp eye on business and share price valuation fundamentals.

Bad February, as Expected: February was quite weak as expected due to seasonality and Chinese New Year that fell on February 10 this year. Semiconductor industry statistics for world-wide sales released by the Semiconductor Industry Association (SIA) this week reflected a three-month rolling average decline of -3.8% compared to an average contraction of -2.2% over the last 23 years with a high of +1.9%, a low of -7.7%, and growth only five times across those two decades—none of which occurred during the last eight years. Europe led for the second month with a gain of +1.4% followed by declines from Asia-Pacific at -3.6%, Japan down by -5.0%, and The Americas bringing up the rear with a decline of -6.2%. It appears that January data was revised upwards consistent with sentiment I expressed last month, although it only aggravated the February decline at this point.

Next month's release of March data should be fairly healthy as seasonality turns favorable and Chinese New Year gets out of the way. March has averaged a gain of +2.6% with a high of +7.0%, a low of -6.9%, and has declined only three times in the last 23 years, none of which occurred over the last 11 years.

Weak 1Q: March will be up, but 1Q will likely be down sequentially by -5% or thereabouts. The first quarter is a seasonally slack period that has averaged a decline of -1.9% with a high of +8.8% and a low of -19.4%, but has only been positive during nine of the last 22 years—and only twice in the last eight years. Weighted revenue guidance from companies in the Tokeneke Universe calls for a below-average decline of -5.2% with a range of -8.0% to -2.4%. The trickle of preannouncements and updates so far have barely moved the needle on the mid-point with an improvement of only 5 basis points with a narrowing of the range of end points by 18 basis points at the low-end and 7 at the high-end. Market researchers continue to forecast mid-single-digit sales growth for the chip industry this year with strength expected from smartphones, tablets and automotive markets while PCs remain weak.

Chip Sector Rally Stalls: The good news is that chip sector share prices continued to rally last month, but the bad news is that the sector underperformed relative to broader market indices and is no longer soundly exceeding them on a year-to-date basis across all metrics. Basically, the rally across the sector is deteriorating.

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The Philadelphia Semiconductor Index Option (SOX) gained +2.4% last month, the average stock in the Tokeneke Universe advanced by +2.7%, and 61 out of 101 of those issues posted gains—that much is good. Unfortunately, March gains in the SOX were less than February's +3.4%, and February's were less than January's +7.5%. Also, for the first time this year the SOX underperformed relative to broader market indices last month with the NASDAQ, S&P500 and DOW posting gains of +3.4%, +3.6%, and +3.7%, respectively. And finally, year-to-date the gains have narrowed with the SOX up by +13.7% compared to those same three indices with gains of +8.2%, +10.0% and +11.3%, respectively. However, this SOX advantage is not shared by the Market Vectors Semiconductor ETF (SMH) which is up by +9.9% year-to-date, nor the average stock in my Universe which is up by +9.5%—both of which are now underperforming relative to the S&P500 and DOW (but doing better than the NASDAQ). The topping-out of the chip sector in mid-February that I noted last month appears to be occurring.

March			
Winners *(61/101)*		Losers	
HIMX	68.6%	TXCC	-40.9%
AMBA	57.2%	MSPD	-25.4%
MOSY	35.7%	MEMS	-20.9%
ACTS	24.3%	RDA	-14.7%
MU	19.1%	SQNS	-11.2%
average stock +2.7%		*SOX +2.4%*	

1Q			
Winners *(69/101)*		Losers	
HIMX	126.3%	GIG	-43.9%
SPWR	105.3%	PSMI	-36.2%
ACTS	59.1%	SQNS	-32.1%
MU	57.3%	MSPD	-29.1%
ADNC	46.8%	EZCH	-27.0%
average stock +9.5%		*SOX +13.7%*	

Indices	*Mar*	*1Q*
SOX	2.4%	13.7%
SMH	1.2%	9.9%
NASDAQ	3.4%	8.2%
S&P500	3.6%	10.0%
DOW	3.7%	11.3%

TR CAP, Cancel That: Last month I introduced Tokeneke Research Capitalization, or TR CAP, that measures changes in the stock market capitalization of the sum total of all issues in the Tokeneke Universe to gage funds flowing in and out of the sector. Aside from perturbations from market cap monsters INTC and QCOM, it appears to be tracking too closely with the S&P500 to offer any insight into semiconductor sector differentiation. I will continue to monitor this metric but will withhold visibility until it earns some through experience, in my opinion.

Chip Sector Outlook 'Depends': I am having a very difficult time generalizing semiconductor industry business conditions at this point. PCs are weak and entering a seasonal trough, but DRAMs are strong. Smartphones and tablets are strong, but the market is heavily concentrated and not all chip suppliers are benefiting. Consumer markets are entering seasonal strength, but end-markets for video games, TVs, camera and toys are subdued. Wireless infrastructure markets promise strength pending the LTE roll-out, but actual purchase orders are elusive.

1Q Earnings season begins in two weeks and I expect share price fluctuations to primarily respond to 2Q guidance on an equity by equity basis since we already have a pretty good idea how bad last quarter was. So how are sector share prices likely to respond? Well, it depends: it depends on the stock; it depends on the share price valuation; it depends on reported 1Q earnings; it depends on 2Q guidance; it depends on investor expectations; it depends on end-market consumption health; and it depends on competitive supply dynamics. So, how to play this mix-master? Pick stocks. Specifically, stocks with favorable business and share price valuation fundamentals.

Stock Picking Case Studies: Indulge me with three overly-simplified examples of popular semiconductor equities: QCOM, INTC and MU. QCOM has a front-row seat in the great growth market for smartphones, but the share price valuation already reflects its expected success in my opinion, and I do not consider the shares compelling at current price levels. QCOM: Good market, bad stock. INTC, on the other hand, has a relatively attractive share price valuation in my opinion, but this potential opportunity is largely offset by PC market weakness. INTC: Bad market, good stock. Conversely, MU is benefiting from memory market price appreciation (see the charts on Page 5) and DRAM supplier consolidation despite PC market weakness while the share price offers considerably more upside potential than downside risk, in my opinion. MU: Good market, good stock. Pick this stock, in my opinion.

Skew the Odds More Heavily in Your Favor: Semiconductor industry business conditions are weak overall, but pockets of strength exist. And the chip sector and broader equity markets have rallied nicely since the beginning of the year despite sector business weakness and a vast array of economic and political risks. While the risk-reward trade-off has shifted unfavorably at the macro level over the last month, attractive investment opportunities continue to exist in the sector as noted in my latest Chip Investment Ideas publication and company specific reports, in my opinion. I recommend to carefully pick stocks with even more pronounced attractive fundamental valuations to mitigate potential downside risk—but only so much as discomfort will allow for your particular situation.

—Dan K. Scovel
Semiconductor Analyst

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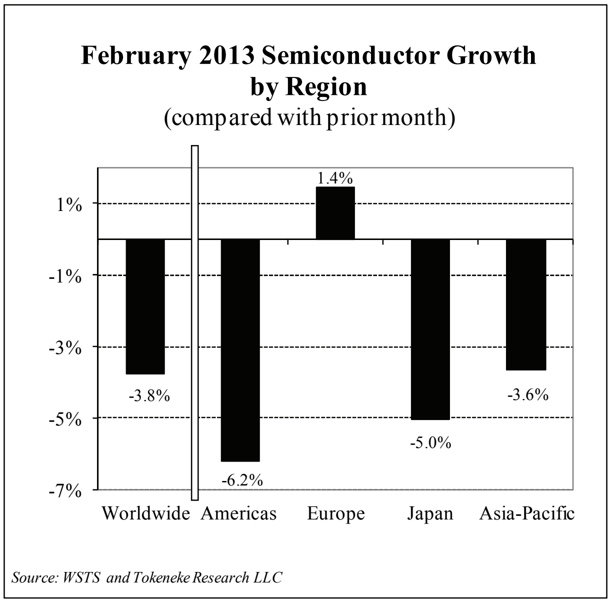

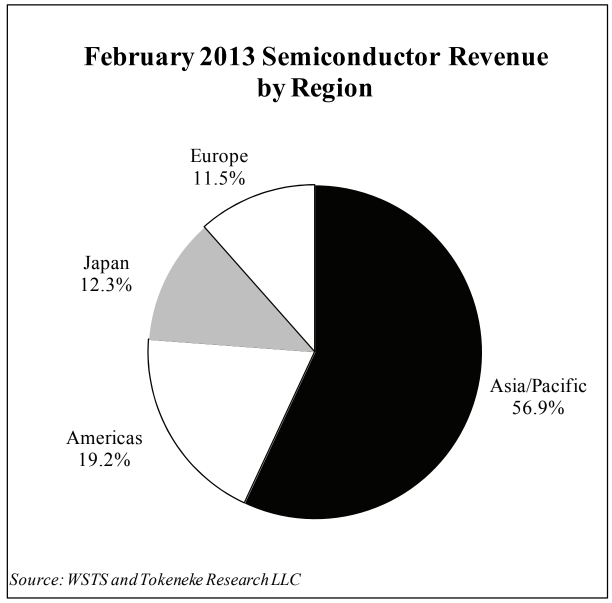

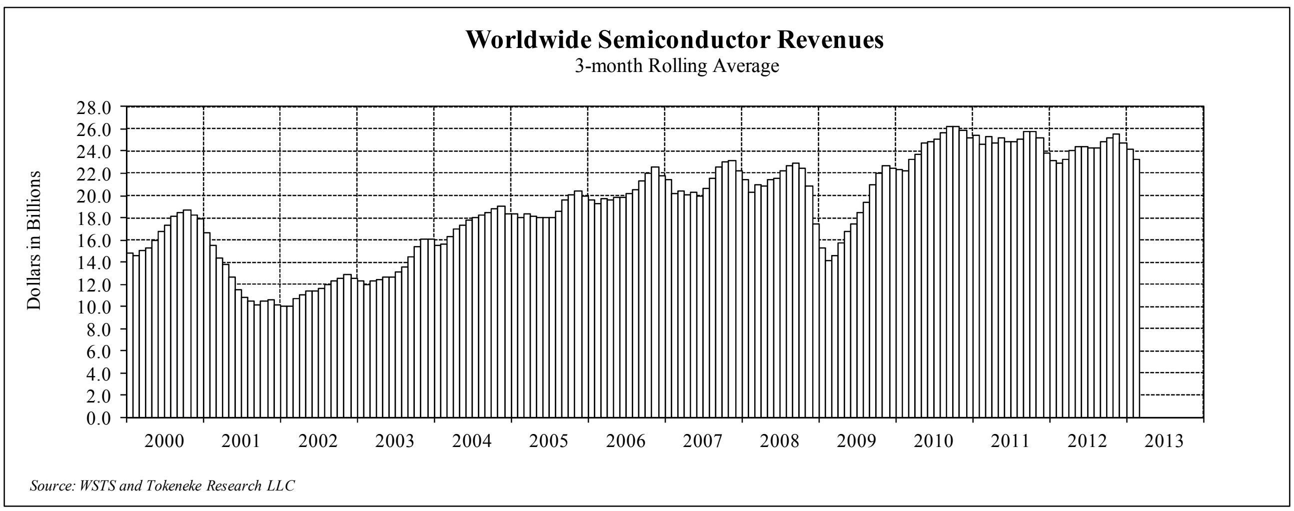

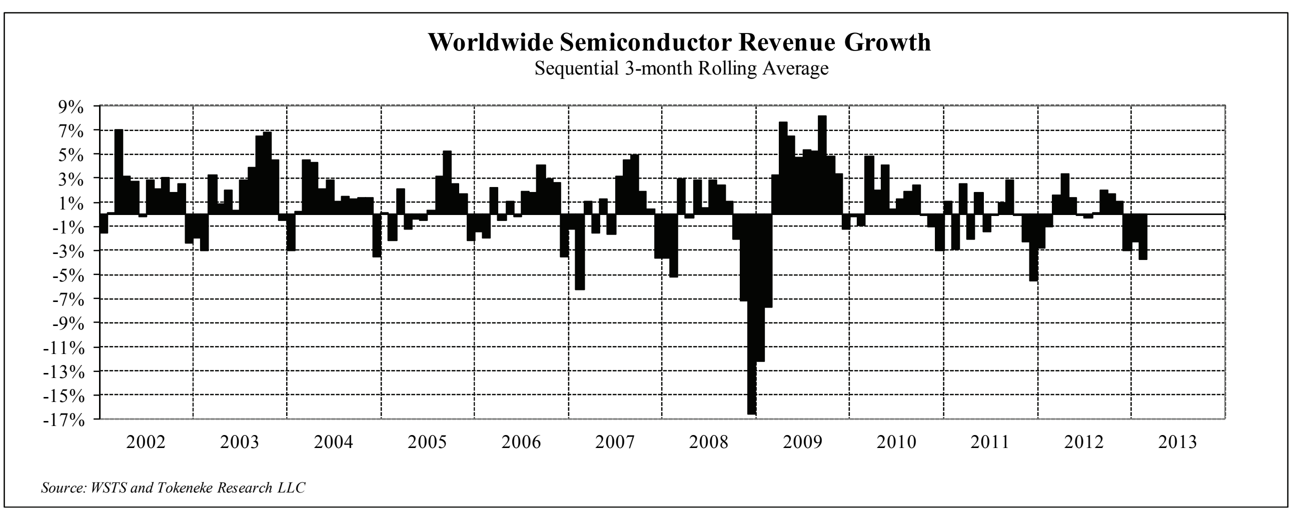

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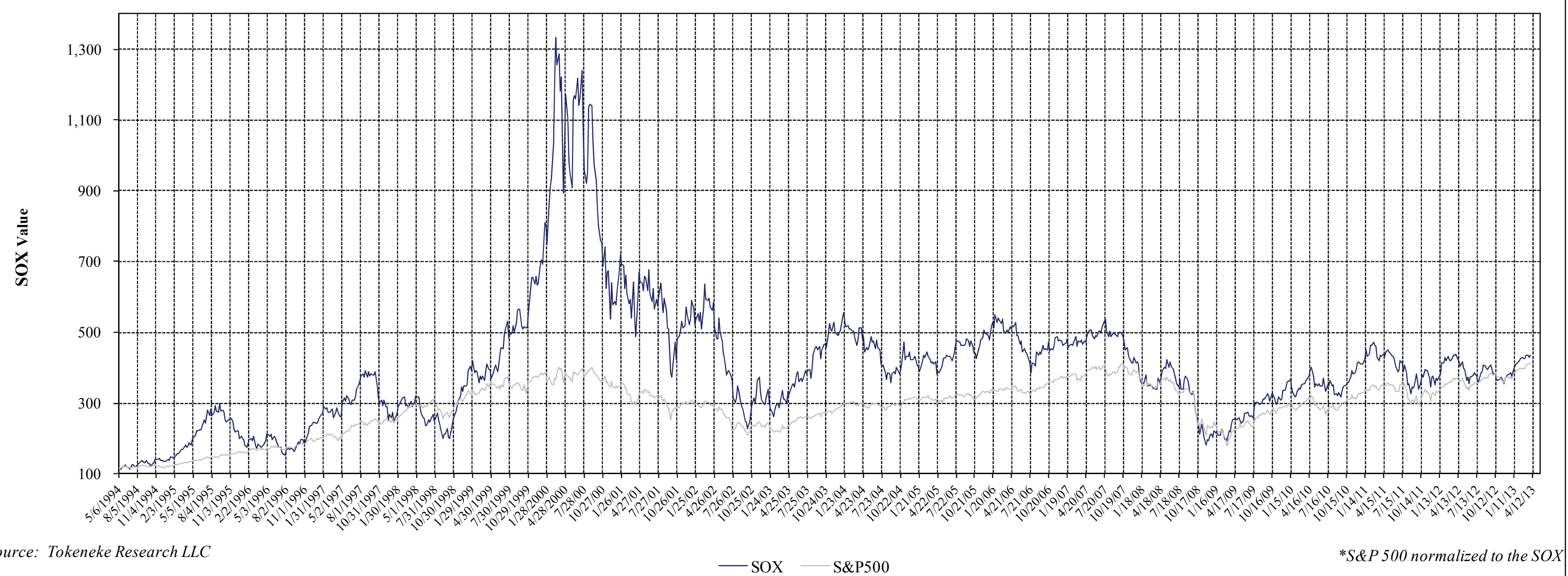
Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



Source: Tokeneke Research LLC

*S&P 500 normalized to the SOX

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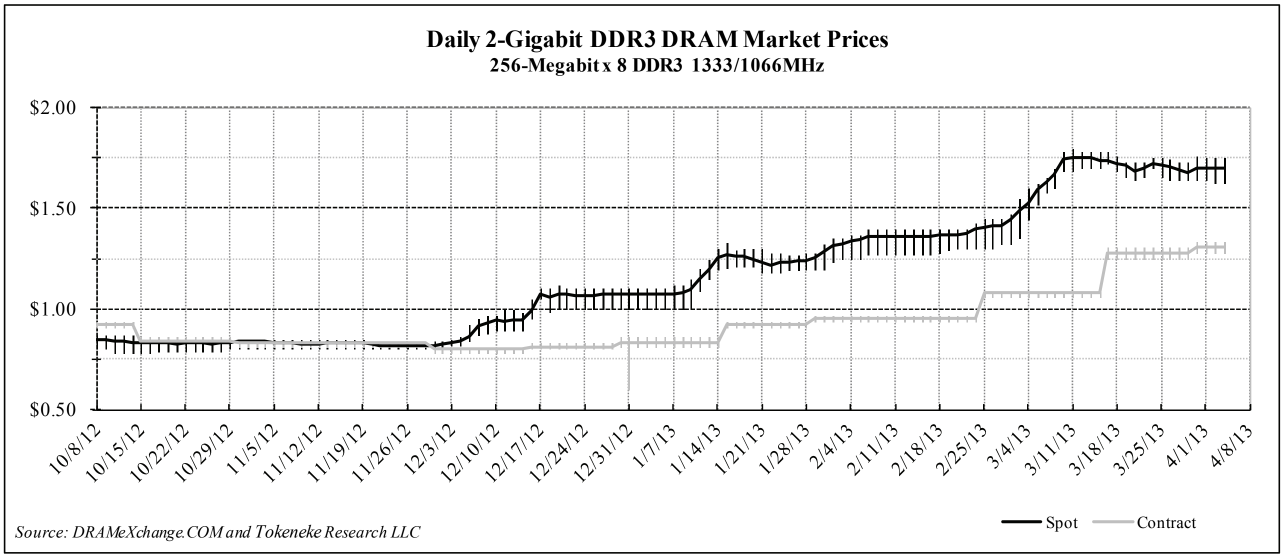

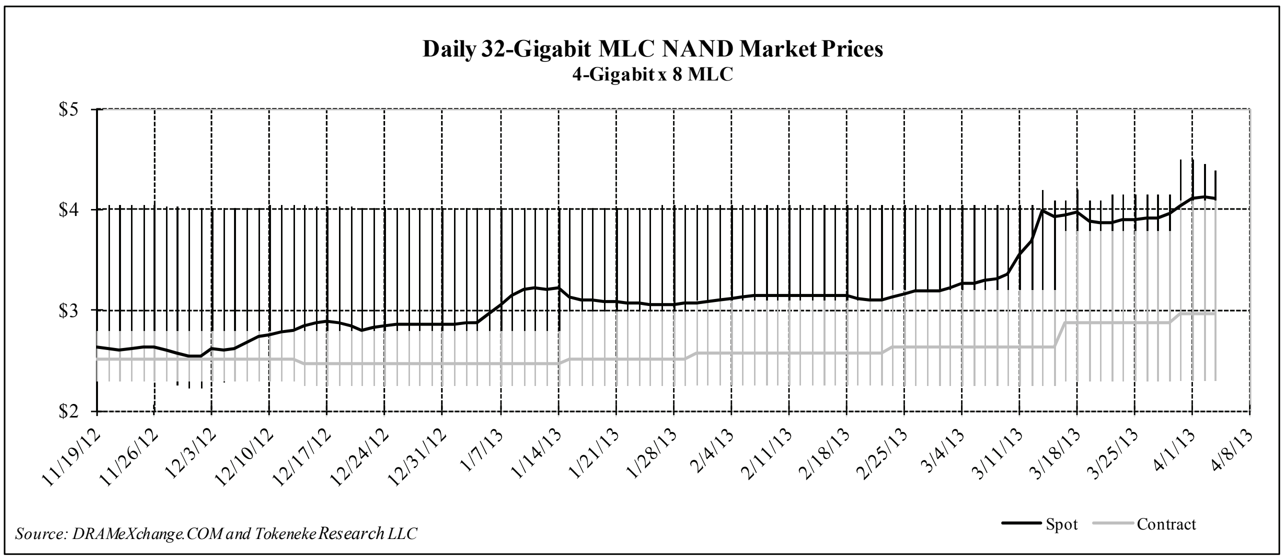

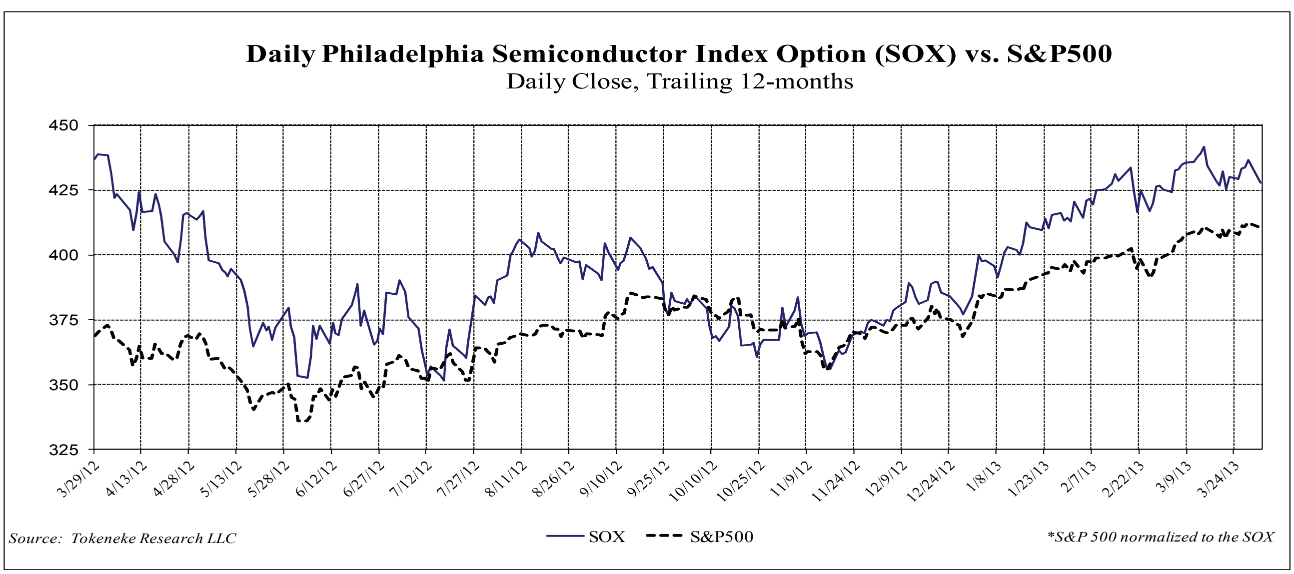

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The Company

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- *Monthly Newsletter:* A summarized review of noteworthy industry business developments, sales statistics, and sector equity market performance, as well as a near-term and annual outlook for sector business fundamentals and share prices. This report typically includes two pages of text and a handful of recurring charts and tables. It is intended for relatively broad-based distribution.
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My Background

I have an electrical engineering background, nearly 12 years of semiconductor industry experience, and was on Wall Street for nearly eight years where I was selected as the Best On The Street semiconductor analyst for 2002 by The Wall Street Journal, and third-rated Best of the Best across all sectors.

I obtained my undergraduate BS degree in electrical engineering from the University of Washington, and my MBA from Santa Clara University. My industry experience consists of nearly 12 years in various technical sales and marketing roles at four different semiconductor firms located in Silicon Valley beginning with Advanced Micro Devices in 1984, followed by two small start-up companies, and ending at Cirrus Logic where I supported the firm's Japanese market development. I joined Fahnestock & Co. as a senior semiconductor analyst in 1996 and was recruited by Needham & Co. in April 2000.

My formal coverage list as a sell-side analyst included the following equities: AMD, ALSC, ALTR, ARTI, ATML, CUBE, CY, ESST, GNSS, INTC, ISSI, LSI, MOSY, MU, OIIM, OVTI, RMTR, SIII, SMSC, STEC, SVTG, TDFX, TSRA, TXN, and ZRAN.

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